

ARC DOCUMENT SOLUTIONS, INC.
Form 10-Q
August 04, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2016

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 001-32407

ARC DOCUMENT SOLUTIONS, INC.
(Exact name of Registrant as specified in its Charter)

Delaware 20-1700361
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

1981 N. Broadway, Suite 385

Walnut Creek, California 94596

(925) 949-5100

(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of July 29, 2016, there were 47,389,907 shares of the issuer's common stock outstanding.

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Form 10-Q
For the Quarter Ended June 30, 2016
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FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains statements that are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. When used in this Form 10-Q, the words “believe,” “expect,” “anticipate,” “estimate,” “intend,” “plan,” “project,” “target,” “likely,” “will,” “would,” “could,” and variations of such words and expressions as they relate to our management or to ARC Document Solutions, Inc. (the “Company”) are intended to identify forward-looking statements. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those contemplated herein. We have described in Part II, Item 1A-“Risk Factors” a number of factors that could cause our actual results to differ from our projections or estimates. These factors and other risk factors described in this Form 10-Q are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could harm our results. Consequently, there can be no assurance that the actual results or developments anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to, or effects on, us. Given these uncertainties, you are cautioned not to place undue reliance on such forward-looking statements.

Except where otherwise indicated, the statements made in this Form 10-Q are made as of the date we filed this report with the Securities and Exchange Commission and should not be relied upon as of any subsequent date. All future written and verbal forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We undertake no obligation, and specifically disclaim any obligation, to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. You should, however, consult further disclosures we make in future filings of our Forms 10-K, Forms 10-Q, and Forms 8-K, and any amendments thereto, as well as our proxy statements.

PART I—FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

ARC DOCUMENT SOLUTIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except per share data)	June 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$20,452	\$ 23,963
Accounts receivable, net of allowances for accounts receivable of \$1,850 and \$2,094	60,933	60,085
Inventories, net	19,570	16,972
Prepaid expenses	4,766	4,555
Other current assets	4,347	4,131
Total current assets	110,068	109,706
Property and equipment, net of accumulated depreciation of \$206,584 and \$202,457	57,754	57,590
Goodwill	138,688	212,608
Other intangible assets, net	15,580	17,946
Deferred income taxes	76,019	74,196
Other assets	2,372	2,492
Total assets	\$400,481	\$ 474,538
Liabilities and Equity		
Current liabilities:		
Accounts payable	\$22,148	\$ 23,989
Accrued payroll and payroll-related expenses	11,811	12,118
Accrued expenses	18,023	19,194
Current portion of long-term debt and capital leases	14,863	14,374
Total current liabilities	66,845	69,675
Long-term debt and capital leases	150,059	157,018
Deferred income taxes	29,412	35,933
Other long-term liabilities	2,623	2,778
Total liabilities	248,939	265,404
Commitments and contingencies (Note 6)		
Stockholders' equity:		
ARC Document Solutions, Inc. stockholders' equity:		
Preferred stock, \$0.001 par value, 25,000 shares authorized; 0 shares issued and outstanding	—	—
Common stock, \$0.001 par value, 150,000 shares authorized; 47,390 and 47,130 shares issued and 46,008 and 47,029 shares outstanding	47	47
Additional paid-in capital	116,494	115,089
Retained earnings	36,357	89,687
Accumulated other comprehensive loss	(2,653)	(2,097)
Less cost of common stock in treasury, 1,382 and 101 shares	5,709	612
Total ARC Document Solutions, Inc. stockholders' equity	144,536	202,114
Noncontrolling interest	7,006	7,020
Total equity	151,542	209,134
Total liabilities and equity	\$400,481	\$ 474,538

The accompanying notes are an integral part of these condensed consolidated financial statements.

ARC DOCUMENT SOLUTIONS, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share data)	2016	2015	2016	2015
Service sales	\$92,581	\$99,336	\$183,216	\$192,661
Equipment and supplies sales	11,189	14,053	24,104	25,047
Total net sales	103,770	113,389	207,320	217,708
Cost of sales	67,378	72,530	137,191	140,828
Gross profit	36,392	40,859	70,129	76,880
Selling, general and administrative expenses	25,503	27,132	51,859	54,587
Amortization of intangible assets	1,232	1,442	2,545	2,931
Goodwill impairment	73,920	—	73,920	—
Restructuring expense	5	11	7	85
(Loss) income from operations	(64,268)	12,274	(58,202)	19,277
Other income, net	(15)	(30)	(38)	(56)
Loss on extinguishment of debt	44	97	90	97
Interest expense, net	1,526	1,939	2,972	3,796
(Loss) income before income tax (benefit) provision	(65,823)	10,268	(61,226)	15,440
Income tax (benefit) provision	(10,015)	811	(8,046)	1,572
Net (loss) income	(55,808)	9,457	(53,180)	13,868
Income attributable to the noncontrolling interest	(96)	(200)	(150)	(175)
Net (loss) income attributable to ARC Document Solutions, Inc. shareholders	\$(55,904)	\$9,257	\$(53,330)	\$13,693
(Loss) earnings per share attributable to ARC Document Solutions, Inc. shareholders:				
Basic	\$(1.22)	\$0.20	\$(1.15)	\$0.29
Diluted	\$(1.22)	\$0.19	\$(1.15)	\$0.29
Weighted average common shares outstanding:				
Basic	45,955	46,611	46,285	46,528
Diluted	45,955	47,558	46,285	47,634

The accompanying notes are an integral part of these condensed consolidated financial statements.

ARC DOCUMENT SOLUTIONS, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
 (Unaudited)

(In thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net (loss) income	\$(55,808)	\$9,457	\$(53,180)	\$13,868
Other comprehensive (loss) income, net of tax				
Foreign currency translation adjustments, net of tax	(935)	315	(623)	(90)
Fair value adjustment of derivatives, net of tax	(2)	(83)	(97)	(194)
Other comprehensive (loss) income, net of tax	(937)	232	(720)	(284)
Comprehensive (loss) income	(56,745)	9,689	(53,900)	13,584
Comprehensive (loss) income attributable to noncontrolling interest	(116)	231	(14)	207
Comprehensive (loss) income attributable to ARC Document Solutions, Inc. shareholders	\$(56,629)	\$9,458	\$(53,886)	\$13,377

The accompanying notes are an integral part of these condensed consolidated financial statements.

ARC DOCUMENT SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF EQUITY
(Unaudited)

(In thousands, except per share data)	ARC Document Solutions, Inc. Shareholders								
	Common Stock		Additional Paid-in Capital	Retained Deficit	Accumulated		Common Stock in Treasury	Noncontrolling Interest	Total
	Shares	Par Value			Other Comprehensive Loss				
Balance at December 31, 2014	46,800	\$ 47	\$ 110,650	\$(7,353)	\$ (161)	\$(408)	\$ 7,063	\$ 109,838	
Stock-based compensation	131	—	2,275	—	—	—	—	2,275	
Issuance of common stock under Employee Stock Purchase Plan	8	—	58	—	—	—	—	58	
Stock options exercised	125	—	561	—	—	—	—	561	
Treasury shares	24	—	—	—	—	(204)	—	(204)	
Comprehensive income:									
Net income	—	—	—	13,693	—	—	175	13,868	
Foreign currency translation adjustments, net of tax	—	—	—	—	(122)	—	32	(90)	
Fair value adjustment of derivatives, net of tax	—	—	—	—	(194)	—	—	(194)	
Comprehensive income								13,584	
Balance at June 30, 2015	47,088	\$ 47	\$ 113,544	\$ 6,340	\$ (477)	\$(612)	\$ 7,270	\$ 126,112	

(In thousands, except per share data)	ARC Document Solutions, Inc. Shareholders								
	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated		Common Stock in Treasury	Noncontrolling Interest	Total
	Shares	Par Value			Other Comprehensive Loss				
Balance at December 31, 2015	47,130	\$ 47	\$ 115,089	\$ 89,687	\$ (2,097)	\$(612)	\$ 7,020	\$ 209,134	
Stock-based compensation	229	—	1,423	—	—	—	—	1,423	
Issuance of common stock under Employee Stock Purchase Plan	19	—	70	—	—	—	—	70	
Stock options exercised	12	—	30	—	—	—	—	30	
Tax deficiency from stock based compensation			(118)					(118)	
Treasury shares	—	—	—	—	—	(5,097)	—	(5,097)	
Comprehensive income:									
Net (loss) income	—	—	—	(53,330)	—	—	150	(53,180)	
Foreign currency translation adjustments, net of tax	—	—	—	—	(459)	—	(164)	(623)	
Fair value adjustment of derivatives, net of tax	—	—	—	—	(97)	—	—	(97)	
Comprehensive loss								(53,900)	
Balance at June 30, 2016	47,390	\$ 47	\$ 116,494	\$ 36,357	\$ (2,653)	\$(5,709)	\$ 7,006	\$ 151,542	

The accompanying notes are an integral part of these condensed consolidated financial statements.

ARC DOCUMENT SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2016	2015	2016	2015
Cash flows from operating activities				
Net (loss) income	\$ (55,808)	\$ 9,457	\$ (53,180)	\$ 13,868
Adjustments to reconcile net income to net cash provided by operating activities:				
Allowance for accounts receivable	249	156	320	182
Depreciation	6,658	7,078	13,335	14,144
Amortization of intangible assets	1,232	1,442	2,545	2,931
Amortization of deferred financing costs	115	161	233	322
Goodwill impairment	73,920	—	73,920	—
Stock-based compensation	651	921	1,423	2,004
Deferred income taxes	(10,066)	3,847	(8,317)	6,023
Deferred tax valuation allowance	(87)	(3,257)	(15)	(4,791)
Loss on early extinguishment of debt	44	97	90	97
Other non-cash items, net	(119)	(110)	(453)	(284)
Changes in operating assets and liabilities:				
Accounts receivable	(124)	(2,111)	(1,388)	(6,633)
Inventory	(1,199)	(1,765)	(2,767)	(2,858)
Prepaid expenses and other assets	(1,063)	(282)	(666)	1,717
Accounts payable and accrued expenses	2,177	1,230	(3,197)	(4,570)
Net cash provided by operating activities	16,580	16,864	21,883	22,152
Cash flows from investing activities				
Capital expenditures	(2,645)	(4,136)	(5,150)	(7,637)
Other	481	93	707	248
Net cash used in investing activities	(2,164)	(4,043)	(4,443)	(7,389)
Cash flows from financing activities				
Proceeds from stock option exercises	19	16	30	561
Proceeds from issuance of common stock under Employee Stock Purchase Plan	31	31	70	58
Share repurchases	(2,364)	(204)	(5,097)	(204)
Contingent consideration on prior acquisitions	(302)	—	(367)	—
Early extinguishment of long-term debt	(4,600)	(7,250)	(9,000)	(7,250)
Payments on long-term debt agreements and capital leases	(3,220)	(6,713)	(6,341)	(12,780)
Net repayments under revolving credit facilities	—	(760)	—	(1,744)
Payment of deferred financing costs	—	(1)	(30)	(25)
Payment of hedge premium	—	—	—	(632)
Net cash used in financing activities	(10,436)	(14,881)	(20,735)	(22,016)
Effect of foreign currency translation on cash balances	(321)	(65)	(216)	53
Net change in cash and cash equivalents	3,659	(2,125)	(3,511)	(7,200)
Cash and cash equivalents at beginning of period	16,793	17,561	23,963	22,636
Cash and cash equivalents at end of period	\$ 20,452	\$ 15,436	\$ 20,452	\$ 15,436
Supplemental disclosure of cash flow information				

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Noncash investing and financing activities

Capital lease obligations incurred	\$5,742	\$3,542	\$8,607	\$7,042
Contingent liabilities in connection with acquisition of businesses	\$—	\$—	\$89	\$—
Liabilities in connection with deferred financing fees	\$76	\$—	\$76	\$—

The accompanying notes are an integral part of these condensed consolidated financial statements.

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ARC DOCUMENT SOLUTIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data or where otherwise noted)

(Unaudited)

1. Description of Business and Basis of Presentation

ARC Document Solutions, Inc. (“ARC Document Solutions,” “ARC” or the “Company”) is a leading document solutions provider to design, engineering, construction, and facilities management professionals, while also providing document solutions to businesses of all types. ARC offers a variety of services including: Construction Document Information Management (“CDIM”), Managed Print Services (“MPS”), and Archive and Information Management (“AIM”). In addition, ARC also sells Equipment and Supplies. The Company conducts its operations through its wholly-owned operating subsidiary, ARC Document Solutions, LLC, a Texas limited liability company, and its affiliates.

Basis of Presentation

The accompanying interim Condensed Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and in conformity with the requirements of the SEC. As permitted under those rules, certain footnotes or other financial information required by GAAP for complete financial statements have been condensed or omitted. In management’s opinion, the accompanying interim Condensed Consolidated Financial Statements presented reflect all adjustments of a normal and recurring nature that are necessary to fairly present the interim Condensed Consolidated Financial Statements. All material intercompany accounts and transactions have been eliminated in consolidation. The operating results for the three and six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the interim Condensed Consolidated Financial Statements and accompanying notes. The Company evaluates its estimates and assumptions on an ongoing basis and relies on historical experience and various other factors that it believes to be reasonable under the circumstances to determine such estimates. Actual results could differ from those estimates, and such differences may be material to the interim Condensed Consolidated Financial Statements.

These interim Condensed Consolidated Financial Statements and accompanying notes should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2015 Form 10-K.

Recent Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-09, Improvements to Employee Share-Based Payment Accounting. The new guidance requires excess tax benefits and tax deficiencies to be recorded in the statement of operations when share-based awards vest or are settled. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity apart from other income tax cash flows. The standard also allows the Company to repurchase more of an employee’s shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made on an employee’s behalf for withheld shares should be presented as a financing activity on the Company’s statement of cash flows, and provides an accounting policy election to account for forfeitures as they occur. ASU 2016-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is permitted. The Company is currently in the process of evaluating the impact of the adoption of ASU 2016-09 on its condensed consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Codification (“ASC”) 842, Leases. The new guidance replaces the existing guidance in ASC 840, Leases. ASC 842 requires a dual approach for lessee accounting under which a lessee would account for leases as finance leases or operating leases. Both finance leases and operating leases will result in the lessee recognizing a right-of-use (ROU) asset and a corresponding lease liability. For finance leases the lessee would recognize interest expense and amortization of the ROU asset and for operating leases the lessee would recognize a straight-line total lease expense. ASC 842 is effective for fiscal years, and interim periods within

those years, beginning after December 15, 2018. The Company is currently in the process of evaluating the impact of the adoption of ASC 842 on its consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory. The new guidance requires that inventory be measured at the lower of cost or net realizable value and amends existing guidance which requires inventory be measured at the lower of cost or market. Replacing the concept of market with the single measurement of net realizable value is intended to create efficiencies for financial statement preparers. ASU 2015-11 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is permitted. The Company is currently in the process of evaluating the impact of the adoption of ASU 2015-11 on its condensed consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the existing revenue recognition requirements in "Revenue Recognition (Topic 605)." The new guidance requires entities to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received in exchange for those goods or services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is currently in the process of evaluating the impact of the adoption of ASU 2014-09 on its condensed consolidated financial statements.

In April 2015, the FASB issued ASU 2015-05, Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. The new guidance amends Accounting Standards Codification ("ASC") 350-40, Intangibles - Goodwill and Other, Internal-Use Software, to provide guidance on determining whether a cloud computing arrangement contains a software license that should be accounted for as internal-use software. ASU 2015-05 is effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. The Company adopted ASU 2015-05 on January 1, 2016. The adoption of ASU 2015-05 did not have a material impact to the Company's condensed consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which changes the presentation of deferred financing fees in an entity's financial statements. Under the ASU, deferred financing fees are to be presented in the balance sheet as a direct deduction from the related debt liability rather than as an asset. ASU 2015-03 is effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. The Company adopted ASU 2015-03 as of January 1, 2016. In conjunction with the adoption of ASU 2015-03, the Company reclassified net deferred financing fees of \$1.6 million at December 31, 2015 from an asset to a direct deduction from the related debt liability to conform to the current period presentation.

Segment Reporting

The provisions of ASC 280, Disclosures about Segments of an Enterprise and Related Information, require public companies to report financial and descriptive information about their reportable operating segments. The Company identifies operating segments based on the various business activities that earn revenue and incur expense and whose operating results are reviewed by the Company's Chief Executive Officer, who is the Company's chief operating decision maker. Because its operating segments have similar products and services, classes of customers, production processes, distribution methods and economic characteristics, the Company operates as a single reportable segment. Net sales of the Company's principal services and products were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Service Sales				
CDIM	\$54,860	\$58,835	\$108,525	\$113,477
MPS	34,055	37,134	67,286	73,011
AIM	3,666	3,367	7,405	6,173
Total service sales	92,581	99,336	183,216	192,661
Equipment and supplies sales	11,189	14,053	24,104	25,047
Total net sales	\$103,770	\$113,389	\$207,320	\$217,708

Risk and Uncertainties

The Company generates the majority of its revenue from sales of services and products to customers in the architectural, engineering, construction and building owner/operator (AEC/O) industry. As a result, the Company's operating results and financial condition can be significantly affected by economic factors that influence the AEC/O industry, such as non-residential construction spending, GDP growth, interest rates, unemployment rates, and office

vacancy rates. Reduced activity (relative to historic levels) in the AEC/O industry would diminish demand for some of ARC's services and products, and would therefore negatively affect revenues and have a material adverse effect on its business, operating results and financial condition.

As part of the Company's growth strategy, ARC intends to continue to offer and grow a variety of service offerings that are relatively new to the Company. The success of the Company's efforts will be affected by its ability to acquire new customers for the Company's new service offerings, as well as to sell the new service offerings to existing customers. The Company's inability to successfully

market and execute these relatively new service offerings could significantly affect its business and reduce its long term revenue, resulting in an adverse effect on its results of operations and financial condition.

2. Earnings per Share

The Company accounts for earnings per share in accordance with ASC 260, Earnings Per Share. Basic earnings per share is computed by dividing net income attributable to ARC by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is computed similarly to basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if common shares subject to outstanding options and acquisition rights had been issued and if the additional common shares were dilutive. Common share equivalents are excluded from the computation if their effect is anti-dilutive. For the three and six months ended June 30, 2016, stock options of 4.4 million common shares were excluded from the calculation of diluted net loss attributable to ARC per common share because they were anti-dilutive. For the three and six months ended June 30, 2015, stock options of 1.6 million and 0.5 million common shares, were excluded from the calculation of diluted net income attributable to ARC per common share because they were anti-dilutive. The Company's common share equivalents consist of stock options issued under the Company's stock plan.

Basic and diluted weighted average common shares outstanding were calculated as follows for the three and six months ended June 30, 2016 and 2015:

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Weighted average common shares outstanding during the period—basic	45,955	46,611	46,285	46,528
Effect of dilutive stock options	—	947	—	1,106
Weighted average common shares outstanding during the p				